DOW THEORY LETTERS INC.

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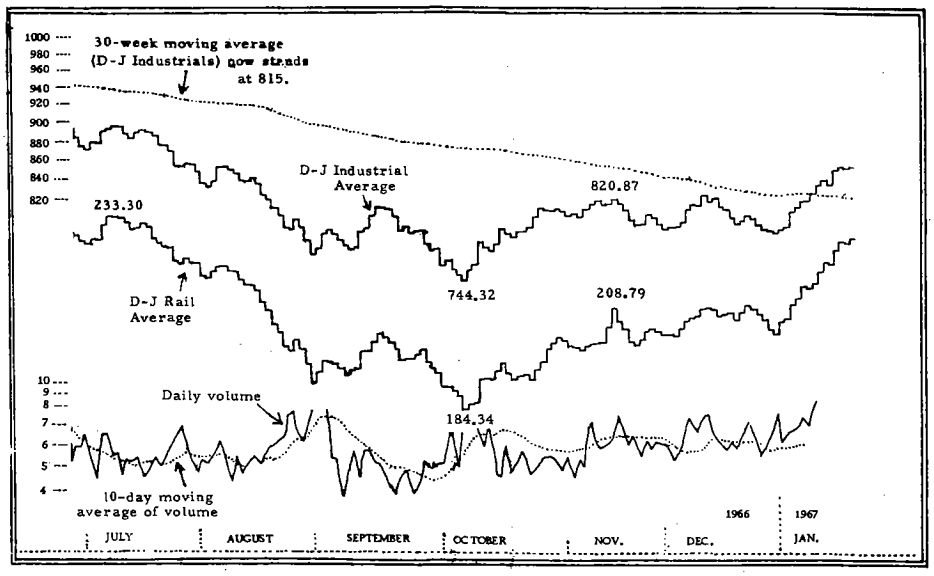
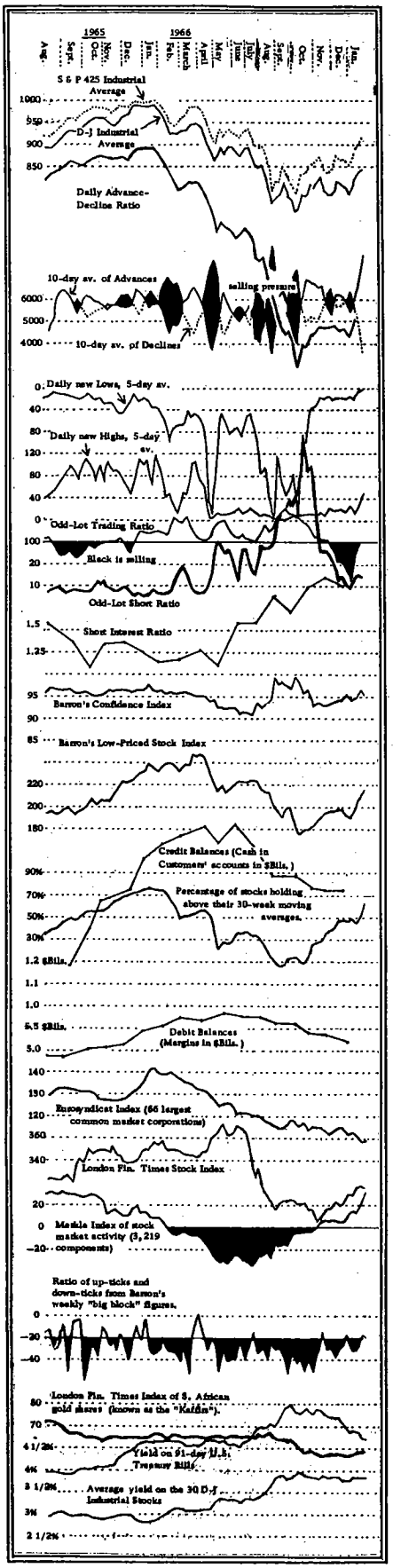
THE MARKET: "Wall Street is inherently bullish," wrote the great Dow Theorist, William Hamilton. "One reason for this is that the financial district does not make money in a bear market, contrary to the idea of those people who think that then is the time when the Street reaps its harvest and wickedly turns disaster to its own advantage. Wall Street lives on commissions, and not on what it might make by selling short the securities that it originates."

During late 1965 and early 1966 Wall Street and the nation ignored the deteriorating technical picture in the market, and instead embraced what appeared to be the "foolproof" fundamentals. A "limited war" in Vietnam was in force, and it was assumed that business would boom while the war continued, whereas if the war ended the nation could immediately switch its war expenditures into peacetime production. President Johnson was riding high in the popularity saddle, and the country was straining its production facilities to keep up with orders. All sectors of the economy were booming, and if money was growing tighter that phenomenon was ignored or explained away.

The bear market started in February, but it was not until mid-year that the persistent erosion in values was taken seriously. By October the D-J Industrials had wiped out almost one-third of their gains of the past 17 years (i.e. the gains of the entire 1949-66 bull market).

In October the big upward correction began. No readers of these Letters should have been startled by the rise. I had been writing that all primary movements are ultimately corrected by counter movements which retrace approximately 1/3 to 2/3 of the preceding primary gains (or losses in a bear market). I had been saying that such counter-trend movements are generally most deceptive and most violent during the second (psychological) phase. Should the Dow now rise to 870, it would succeed in retracing 50% of the 1966 losses. Such a rise, regardless of forthcoming events in the bear market, would not be exceptional. During bear markets the periodic rallies are not brought on by the market discounting coming (bullish) events. Rallies in bear markets are as automatic and mechanical as the rebound of a rubber ball when it is dropped to the floor. Nevertheless, there has probably never been a major correction within a primary bear market which has not had the benefit of "explanations" by bullish analysts anxious to hurry it on its way. As Hamilton said, Wall




1965
1966
S & P 425 Industrial Average
D-J Industrial Average
Daily Advance-Decline Ratio
10-day av. of Advances
selling pressure
10-day av. of Declines
Daily new Lows, 5-day av.
Daily new Highs, 5-day av.
Odd-Lot Trading Ratio
Black is selling
Odd-Lot Short Ratio
Short Interest Ratio
Barron's Confidence Index
Barron's Low-Priced Stock Index
Credit Balances (Cash in Customers' accounts in $Bils.)
Percentage of stocks holding above their 30-week moving averages.
Debit Balances (Margins in $Bils.)
Envsyndicat Index (85 largest common market corporations)
London Fin. Times Stock Index
Merkle Index of stock market activity (3,219 components)
Ratio of up-ticks and down-ticks from Barron's weekly "big block" figures.
London Fin. Times Index of S. African gold shares (known as the "Kaffirs").
Yield on 91-day U.S. Treasury Bills
Average yield on the 30 D-J Industrial Stocks

Street is inherently bullish, and if the market rebounds after a 251 point drop, why not give the public what it wants— bullish rationales.

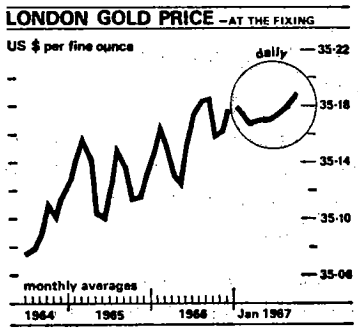
I am also interested in the reverse in psychology now evidenced by Wall Streeters. Whereas they disregarded the technical factors in the market in early 1966, now they are disregarding the fundamentals. I see at least 6 major adverse factors on the financial horizon, any combination of which could spell major troubles for 1967. (1) For the first time since World War II, the economic slump is worldwide. Europe is not going to bail the U.S. out of its current predicaments, and the U.S. is not going to bail Europe out. Last week the Eurosyndicat Index of the 100 leading Common Market corporations dropped to its lowest point in years— to 109.33. (2) The international monetary picture is boiling. Month by month the major European powers are positioning themselves further in line behind France— and against the inflationary policies of the U.S. and Britain. (3) The public sector of the economy in the U.S. is feeding on the private sector, and the continuation of the war practically guarantees this ominous trend. (4) Private capital investment is in the process of reversing to the downside. Furthermore, the confusion brought on by the war and loss of Johnson's prestige in Congress is creating great uncertainty. Corporations do not like to commit new funds amid an atmosphere of uncertainty.

GOLD: A retired friend called me a few days ago and remarked, "Noah had his flood to contend with. Today we have the U.S. flood of paper to contend with. I don't know which is worse." In its latest report, the First National City Bank (N.Y.C.) presents its annual gold roundup, and the Bank states that for the first time in years, all gold production is now going into private hoarding. It is obvious that investors throughout the world are seeking to shelter themselves from the paper flood. They are hoarding the only commodity which they know will withstand the erosion of values in today's watered currencies.

Is gold really as worthless as the New Economists and the inflationists claim? I thought this description from Wilfred Krug's book, "Gold— The World's Real Money," was informative. "Gold.....is one of the most beautiful of the ninety-two elements and one of the heaviest metals known to science. It is the only metal that is yellow in color in its natural state. It does not tarnish when exposed to the air and does not rust when buried in the ground. It always retains its particular beauty, color and lustre. It is the most ductible and malleable of the metals. A troy ounce can be drawn into a fine wire 50 miles long or it can be beaten into a thin film which will cover 100 square feet— over a thousand times thinner than normal paper. Gold is virtually insoluble and proof against nature's reagents. It is inert to most acids and bases. Its refusal to disintegrate, rust or tarnish has resulted in its being regarded as something that can be counted on to look the same and feel the same a century or five centuries ahead.

"Since the earliest history of man, gold has been an object of human desire.....Due to its durability, compactness, ease of movement, beauty, allure and scarcity, gold is more dependable as a store of value than any other commodity. It is therefore highly prized and freely accepted in return for services and in exchange for all other commodities throughout the world. Because of the feeling of security which possession of gold confers, mankind has placed a high value on ownership of this universal metal. Those who accumulated it found it to be the safest retreat and the ultimate refuge in times of financial trouble."

At the end of this month, the Group of 10 is slated to take up the problem of gold. France has been the spokesman for elimination of the gold exchange system and a return to the gold standard (the gold exchange system allows nations to count dollars and pounds— the reserve currencies— as if they were actual gold). This week the London Economist reports: "Far more disturbing than the noises that have been made over the past two weeks (by assorted French leaders) are reports now current here that France may be about to broaden the small domestic gold market in Paris into an international gold market where private hoarders from the four corners of the world might be allowed to bid up gold without restraint from the French authorities.....What such a French move could be expected to do.....is to give a far stronger signal to hoarders than any that has yet been given them, and so increase very heavily the pressures that the central bankers' gold pool would need to meet." In other words, Paris is believed ready to announce that gold may be freely imported into or exported from France. If this occurs, says the Economist, Paris would be ".....immediately established as an international center." The Economist then directs attention to the gold chart which is reproduced on this page.



(5) The rate of corporate profits is reversing to the downside, and this is sure to spell trouble for stocks. My friend Alden Wells, in his latest report, predicts that corporate profits will decline this year "not less than 25%." (6) Finally, the consumer sector of the economy is beginning to sag. I estimate that this trend will continue throughout 1967. These are the fundamentals which are continuing to hold in force even while the rally in the primary bear market continues. They do not add up to a pretty picture.

Subscriptions have arrived here at the highest January rate in eight years. With them have come many letters requesting personal advice. I simply do not have time or energy to render advice on a personal basis, but I will reiterate my position on this market. I advise readers to stay out of all rallies including this one. Wait patiently for the bear market to unfold. Stay liquid so that you will be in position to take advantage of the great, perhaps once-in-a-lifetime values which will arrive as this bear market moves to conclusion over the next few years.

* * * *

I have been asked to explain why I do not consider the price movement from the October, 1966 lows to the present to have constituted a valid Dow Theory "bull signal." First and probably most important, I consider that a primary bear market started in February, 1966. A primary bear market following a bull market of 17 years duration (1949 to 1966) should be expected to be a full fledged bear market in every way. The majority of bear markets undergo three distinct psychological phases (not to be confused with price movements) before completion. In my opinion, the bear market which began in early 1966 has (so far) gone through only its first and the early part of its second phase.

I have discussed the three-phase concept many times, but I will do it again for my many new readers. In the first phase of a bear market stocks sell minus the froth and fervor of the preceding bull market's final speculative stage. Although stocks may be collapsing, business during the first phase usually remains quite good. In the second phase stocks go down in response to obviously deteriorating business conditions. As I have written many times before, the second phase usually produces one or more very deceptive secondary (upward) reactions. In the third or final stage of a bear market stocks go down because investors have run out of money. During this last phase the crowd exits from Wall Street, gloom takes over, and volume dwindles to perhaps 10% of that which occurred at the preceding bull market top.

In July of 1966, when the Industrial Average broke its 1965 low (840), I expressed the opinion that the first phase of the bear market was over and that the bear market was now about to embark on its second phase. I warned subscribers repeatedly that the second phase was

usually the longest and the most deceptive phase. It was here that we could expect at least one very difficult secondary (upward) correction.

In view of what I have written in many previous Letters, the events of today should not have come as a shock to any of my subscribers. The market is now embroiled in what I consider to be a very deceptive second phase correction. Yet readers remain incredulous. How can the market be rising in the face of slumping retail sales, a probable tax rise, a corporate profit squeeze and sagging consumer sentiment, I am asked? In answer I need only recall 1930, when the market produced a tremendous post-crash advance, generated huge upside volume, and corrected slightly better than 50% of all the loss sustained during the September-November, 1929 crash. In retrospect, we now know that this "surprising" advance came in the face of the greatest economic collapse in American history (i.e. 1930 to 1932). I am, of course, not implying that an economic slump of 1930-32 proportions is fated for 1967-68, but I am using the 1930 example to dramatize the fact that markets can rally, false "bull signals" can be given, and upside activity can be intense even though a stock market and business cave-in may be just over the horizon. It is well to remember that every primary movement in history has been corrected by a secondary reaction, and that reaction tends to recover 1/2 to 2/3 of the ground lost (or gained as the case may be) during the preceding primary swing.

In other words, I do not believe that the 8-month drop of 1966 constituted (in either duration or extent) the full bear market correction of the 1949 to 1966 bull market. All logic suggests that there is more to come.

Now I want to make another point. Hamilton and Rhea wrote a good deal about the manner in which bear markets terminate. There is nothing about the action at the October, 1966 lows which corresponds with what Rhea or Hamilton knew about bear market endings. "It is only necessary to point out," wrote Robert Rhea, "that at the end of bear periods the market seems to be immune to further bad news and pessimism. It also appears to have lost its ability to bounce back after severe declines and has every appearance of having reached a state of equilibrium where speculative activity is at low ebb, where offerings do little to depress prices, but where there appears to be no demand sufficient to lift quotations. The market is a dragging affair with but little public participation. Pessimism is rampant, dividends are being passed, some important companies are usually in financial difficulties, and a certain amount of political unrest is generally apparent."

Does that detailed description sound like October, 1966? Does the bouncing, "turn-on-a-dime" structure of October, 1966, have the vaguest resemblance to the dragging, sideways affair of which Rhea was writing? I'm afraid not. Hamilton warned us that the reversal from primary bear market to bull market is never sudden (as was October, 1966). "The conditions which make for a big upward or a big downward movement of the primary class practically never change themselves overnight, however encouraging the first recovery may seem."

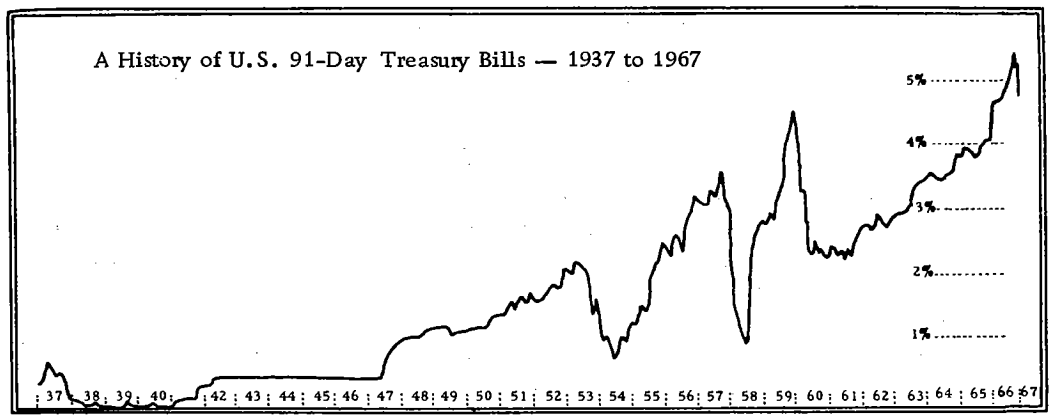
Finally (and least important in my opinion), many are claiming that the price structure from October, 1966, to date follows the typical structure of a reversal from bear to bull market. I take exception to this. According to Dow Theory, a movement terminates at the point where the two Averages (Rails and Industrials) establish their last confirmed highs. The rise from the October 7 low ended 26 days later on November 16, at which point Industrials struck their high peak of 820.87 (even though Rails continued to rally). A correction then took Industrials back to 785.68 on December 30. Following this the two averages rallied to new highs.

It is my opinion that the time element of the initial advance (from October 7 to November 16) was rather too short to qualify as a primary upward swing. The violent, rapid, almost vertical rise of October 7 to November 16 appeared much more to be the first leg of a secondary correction than a new primary leg in a forthcoming bull market. For remember, if this is a new bull market the October 7 to November 16 rise would constitute the first primary bull leg, the November 16 to December 30 decline would have been the first (downward) correction, and we would now be on our second bull leg. I believe that the entire structure since the October 7 low was too small to constitute a reversal from bear to bull market—even discounting the other considerations which I have detailed in preceding paragraphs. In other words, I take the entire movement from the October 7 lows to the present to be a major secondary correction within the context of a continuing primary bear market.

PERSPECTIVE: Much excitment and many hopes are being rekindled by the recent decline in interest rates from their 1966 peaks. There is little question but that the "rationale" behind the current rise in the stock market is the general (many call it "fundamental") decline in interest rates.

The writer talked this week with three of the smartest observers on Wall Street. I asked each of them about the rally in the bond market. Their opinions were clear. One called it "the biggest phoney I have seen in years." Said another, "The speculation in the stock market is nothing compared to what has occurred in bonds. The bond buying today reminds me of the wild speculation in the 'penny stocks' on the American exchange in 1960 and 1961. I've never seen anything like it in the bond market." The third man observed, "The bond market is way, way ahead of itself. It's been listening to and believeing the politicians instead of looking at the facts. The time is past when Washington can call the tune in money. The debt is finally about to reach floodtide, and Washington and the Fed are going to really lose control of the money market in 1967—as they almost did in 1966."

I have my own ideas of coming events in money, and I have expressed a few of them in previous Letters. (1) Put it that this is a primary bear market, and that the economy will contract during 1967 and into late 1968. (2) Put it that the Vietnam war is going



to continue and that expenses are going to mount. (3) Put it that Congress will balk at voting extensive and politically costly cuts in spending plans for the nation. (4) Put it that markets (and particularly world markets) are going to get increasingly vicious and competitive during the months ahead, and that it will be increasingly difficult to pass price rises along to consumers. (5) Put it that coming wage and material costs are going to climb substantially in 1967, and that this will place increasing strain on corporate profits.

If these premises are valid, Government costs are slated to rise substantially (LBJ just announced that defense costs are to careen to $73 billion in fiscal 1968) while Government tax receipts from individuals and corporations are fated to decline. The results will be crisis deficits for the U.S. in the year or so ahead. What would occur in the bond markets if our Government had to finance a $30 or $40 billion deficit in the face of a leveling or declining business picture? The result could be pure chaos in the bond markets, with debt instruments from one end to the other (bills to long-term bonds) skidding to new lows. These are the fundamentals which I see coming up in this long-term bear market.

In order to provide perspective for my subscribers, I have included a chart showing the yields on the bellwether 91-day Treasury bills from the time of their original issuance in 1937 to date. Note that the "reaction" in bills yields so far is miniscule as compared with the rise since 1958 (at which time the Government started running up whopping budget deficits). Note the rising "bottoms" in bill yields and the successive new highs starting with 1954. Finally, note that in 1957-58 and 1960 the Government was able to bring bill yields (and yields in general) down sharply in the face of the business recessions of 1958 and 1960. It will be interesting to see whether Washington will be able to do the same thing in the face of slackening business conditions in 1967. My bet is that the Government will be flabbergasted at how sticky yields are going to be on the downside during 1967. I will bet further that during 1967 we will see bill yields reverse and carry to new highs.

One last observation: One New York friend of mine estimates that Government bond dealers have taken a $5.7 billion dollar position in bonds during early 1967, representing the largest speculative bond position in history. He feels the technical picture in the bond market is now very weak, with dealers "up to their ears" in inventory. Should a reversal in fundamentals now occur, this expert believes that bond yields could rise with dramatic suddeness. In my opinion, this is one of the critical (if not the most critical) areas to watch in 1967. It is the storm over the horizon.

CHART OF THE WEEK: One of the early recession phenomenons is a build up of inventories with a corresponding slowing in the rate of sales. Towards the end of a boom inventories are being accumulated or held in balance based on a steady to rising rate of sales. This means that the inventory-to-sales ratio will either hold steady or decline. But at a certain point the inventorying rate will be too high in relationship to the rate of sales. The inventory-sales ratio will then rise. Finally, near a recession sales will decline faster than the inventory-building rate can be reduced. This results in a rise, often a sharp rise, in the inventory-sales ratio.

The accompanying chart (from the Fed. Res. Bank of St. Louis) shows the inventory-sales ratio now embarking on its first sharp trend-reversal since 1959-60. As seen on the chart, such action has usually occurred just before an economic recession has been officially recognized. The shaded areas on the chart indicate previous post-War recession periods. It should not be long before another such period is both obvious and offically recognized.

At that time we should see business attempting to cut inventories in order to get them in line with sliding sales. It will then be a question of whether inventories can be cut fast enough to catch up with the rate of decline in sales. When the inventory-reducing rate catches up to the rate of declining sales, the rise in the inventory-sales ratio will be over.